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RE

DEC 23 2003

Via Overnight Mail

December 22, 2003

Thomas M. Dorman, Esq.
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

Re: **Case No. 2003-00165**

Dear Mr. Dorman:

Please find enclosed the original and twelve (12) copies of the Main Brief of Kentucky Industrial Utility Customers, Inc. filed in the above-referenced matter.

By copy of this letter, all parties listed on the attached Certificate of Service have been served. Please place these documents of file.

Very Truly Yours,

Michael L. Kurtz

Michael L. Kurtz, Esq.
BOEHM, KURTZ & LOWRY

MLKkew
Attachment

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by mailing a true and correct copy, by regular U.S. mail (unless otherwise noted) to all parties on this 22nd day of December, 2003.

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BEFORE THE
KENTUCKY PUBLIC SERVICE COMMISSION

In The Matter Of: The Application Of Kenergy Corp. For A Review And Approval of Existing Rates	:	**Case No. 2003-00165**

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December 22, 2003

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MAIN BRIEF OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

I. INTRODUCTION

Kenergy Corp. ("Kenergy") is the distribution electric supplier to Kentucky Industrial Utility Customers, Inc. ("KIUC") members, Alcan Aluminum, Century Aluminum (formerly Southwire) ("Smelters"); Weyerhaeuser Paper (formerly Willamette), Commonwealth Aluminum and Kimberly Clark ("Big Three Industrials"). During the test year of Kenergy's long awaited cost of service study that separately tracks the cost of serving direct service customers, KIUC Members paid Kenergy a total of $467,203 in Distribution Fees, despite the fact that Kenergy has no investment in meters, substations, or any other distribution facilities to serve these customers. These customers take service at transmission voltage directly from Big Rivers. The evidence from Kenergy's cost-of-service study demonstrates that the Smelters are currently paying distribution rates to Kenergy which are more than 100% percent above cost of service and that the Big Three Industrials are paying distribution rates which are approximately 200% above cost of service.[1] Kenergy's cost-of-service study also demonstrates that service to the residential and single phase customers is being provided at below cost and that during the

[1] Klepper. Dir. Test. at 7.

test year Kenergy lost $1,774,306 from service to these customers.[2] Kenergy's rates are clearly out of balance. KIUC requests that the Kentucky Public Service Commission ("Commission") order a distribution rate decrease for KIUC Members.

[2] Errata Notice of Applicant Kenergy Corp. Revised Page 1.

II. PROCEDURAL BACKGROUND

On July 1, 1999, Kenergy was formed by the consolidation of Green River Electric Corporation and Henderson Union Electric Cooperative Corp. As promised by the two electric cooperatives, almost immediately upon consolidation, Kenergy filed Case No. 99-162 seeking a 4% total power cost (i.e., generation, transmission and distribution) across the board rate reduction to all of Kenergy's customers except the direct serve industrial customers. The 4% total power cost rate reduction constituted a 10% reduction to distribution rates to all customers except large industrial customers.[3] This Consolidation Credit amounted to a rate decrease of $2,560,798 during the test year.[4] When the Consolidation Credit expires on September 1, 2004, Kenergy will enjoy an automatic rate increase of $2.5 million per year.[5]

In Case No. 99-162, Kenergy produced no cost-of-service evidence supporting its proposal to reduce rates to all but the large customers, and instead based its request upon cost reductions that Kenergy expected to realize as a result of the consolidation. In Case No. 99-162, KIUC did not oppose the rate reduction to the non-direct serve customers. However, KIUC argued that because such customers were receiving a $2.5 million per year rate reduction equal to 10% of the distribution component of their retail rates, the direct serve customers should also receive a corresponding rate reduction equal to 10% of the distribution component of their retail rates. Kenergy's proposed 4% total power cost rate reduction was based on the entire retail cost of power, including wholesale costs for generation and transmission over which Kenergy exercises little control. Very little of Kenergy's anticipated cost reduction was expected to arise (or has arisen) from a reduction in wholesale power

[3] Klepper Dir. Test. at 4-5.
[4] Id. at 5.
[5] Id. at 5.

costs. During the test year the reduction in wholesale power supply costs attributable to the Kenergy consolidation was only $66,132.[6]

The Commission did not order any reduction in distribution rates to the direct serve industrial customers in Case No. 99-162, but rather ordered Kenergy (a) to file a new rate case in late 2000, and (b) to track separately the costs of providing electric power to direct serve industrial customers. In Case No. 2000-395, Kenergy failed to follow the Commission's directives and filed cost-of-service evidence that did not track separately Kenergy's costs of serving direct serve industrial customers. In Case No. 2000-395, the Commission ordered a reduction in Kenergy's Distribution Fees to KIUC members, and also ordered Kenergy to file a new rate proceeding in 2003 specifically so that the distribution fees to direct serve customers could be further reviewed and considered.

In late 2002, Kenergy made a motion to the Commission seeking to extend by one year the time frame for Kenergy's mandated rate filing. By its Order dated December 11, 2002 in Case No. 2000-395, the Commission (a) denied Kenergy's motion, (b) admonished Kenergy that the purpose of the impending rate proceeding was to complete the work that began in Case No. 99-162, and (c) noted that in its Order of June 14, 2000 in Case No. 99-162, the Commission had directed Kenergy that in order "*[t]o adequately address the matter of the assignment of costs to the direct serve customer class, Kenergy should make all necessary changes to its record keeping and cost accounting in order to track any costs it believes are associated with serving such customers.*"[7] The Commission further noted that three years had elapsed since this issue was first raised, and deferring this matter for an additional year would not be reasonable.

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[6] Id. at 5.

[7] Case No. 2000-395, The Application of Kenergy Corporation for a General Adjustment in Existing Rates (Rate Reduction) (KY.PSC June 29, 2001) at 12.

As a consequence of the Commission Order of December 11, 2000, Kenergy has at long last submitted cost-of-service evidence reflecting the costs caused by the direct serve industrial customers. KIUC Members have borne excessive and unfair distribution fees for the past three years because cost-of-service data acceptable to the Commission has not been available. Now that Kenergy has finally submitted such information, the Commission should act to adjust rates in accordance with the cost-of-service evidence, in accordance with the patronage capital evidence, and in a manner to promote economic development.

III. ARGUMENT

1. KIUC Accepts The Results Of Kenergy's Cost-Of-Service Study Subject To One De Minimus Exception

KIUC accepts the cost-of-service study submitted by Kenergy and believes it should be used as the primary consideration in setting rates in this proceeding with one de minimus adjustment. The cost-of-service evidence submitted by Kenergy reflects an allocation of interest on long-term debt to the Class A (Smelters) and Class B (Big Three Industrials) Customers in the amount of $2,546. This allocation of expense is based on allocations of Net General Plant in the amount of $65,287. In other words, the total plant investment made by Kenergy to support sales to the KIUC members is $65,287. The accumulated patronage capital credits held by Kenergy for the benefit of the Smelters and the Big Three Industrial customers is $7,116,532.[8] Therefore, Kenergy retains over $7 million in patronage capital from the KIUC members, versus capital investment of only $65,287 devoted to serving these same customers. In sum, Kenergy is holding over $7 million in monies belonging to the KIUC Members, which Kenergy uses to support investment for other customers and for which the KIUC members receive no recognition through Kenergy's cost-of-service study. If Kenergy did not have $7 million of free capital from the KIUC members, then it would be forced to borrow such monies. The interest on such borrowings would be approximately $350,000 per year and would constitute an additional cost of serving the regular tariff customers.[9] Therefore, it is reasonable to remove the interest expense on KIUC related capital investment from the cost of serving the KIUC members. This adjustment of $2,546 is de minimus, but correct and important conceptually.

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[8] Klepper Dir. Test. at 9.
[9] Id. at 10-11.

2. Kenergy's Cost-of-Service Study And Patronage Capital Balances Reveal That Rates Charged To The KIUC Direct Serve Customers Are Excessive

The cost-of-service evidence overwhelmingly demonstrates that the rates charged to the direct serve customers cannot be justified on a cost causation basis. These cost-of-service results show that the residential and single phase classes are substantially underpaying while the industrial class is grossly overpaying. When combined with the huge patronage capital balances of the KIUC members it is clear that those customers are entitled to a rate decrease.

Kenergy's cost-of-service study is essentially broken into two parts. First, the regular tariff customers (i.e., residential, commercial and small industrial). Second, the large industrial customers served directly off of the Big Rivers transmission system (not the Kenergy distribution system). Kenergy's cost of service study calculated the operating margin earned on sales to each customer class. The operating margin is simply the revenue received minus the expense incurred. As shown on the following chart, Kenergy calculated that it earned a positive operating margin on all classes except Residential & Single Phase. For sales to the Residential & Single Phase class, Kenergy calculated that during the test year it incurred an operating loss of $1,774,306.

	Total System	Lighting Schedule	Residential & Single Phase	HUEC (0-50 kVA)	Three Phase 0-1000 kW	Three Phase Over 1000 kW	Primary Over 1000 kW	Schedule 31 Rural
Operating Margins	**$1,380,634**	**$329,534**	**$(1,774,306)**	**$39,289**	**$2,423,244**	**$177,664**	**$154,066**	**$31,143**

	Total Direct Serve	**Smelters**	**Big Three**	**Other Direct Service**
Operating Margins	**$1,248,000**	**$264,967**	**$202,236**	**$780,798**

As this chart shows, Kenergy made almost as much operating margin ($1,248,000) from the direct serve customers who take delivery at transmission voltage from Big Rivers as the operating margin ($1,380,702) from the regular tariff customers who actually use Kenergy's distribution system. Kenergy's cost-of-service study also showed that the rates charged to the Smelters are more than 100% above Kenergy's cost of service. The rates charged to the other KIUC members (Big Three) are approximately 200% above Kenergy's cost-of-service.[10]

Kenergy now holds $7,116,532 in patronage capital credits for the accounts of the KIUC Members, of which a mere $65,287 is necessary to support the entire capital investment necessary to provide electric service to the KIUC Members. The other $7,051,245 of KIUC member patronage capital is provided as a zero cost subsidy to other Kenergy customers. As mentioned above, if Kenergy did not have $7 million of free capital from the KIUC members, then it would be forced to borrow such monies. The interest on such borrowings would be approximately $350,000 per year and would constitute an additional cost of serving the regular tariff customers.[11] The Kenergy cost-of-service study does not specifically recognize this substantial additional subsidy by the KIUC members to other ratepayers. Therefore, the Kenergy cost of service study understates the level at which the KIUC members are being overcharged for distribution service. The collection from the KIUC Members of further excess revenues to create additional patronage capital would only serve to exacerbate this unfair situation.

[10] Id. at 7.
[11] Id. at 10-11.

3. Commission Precedent And The Fundamental Tenents Of Ratemaking Require That Cost-of-Service Be The Predominant Consideration In Setting Rates

For Kentucky and all other regulated states cost-of-service is, and should be, the predominant consideration in setting rates. The ratemaking principle that costs should be assigned to the cost-causer is deeply ingrained in Kentucky jurisprudence. Administrative Regulation 807 KAR 5:001, Section 10(6) requires that a utility file a cost-of-service study with its rate application, presumably to inform the Commission of the relative costs of serving each customer class. In its February 8, 2001 Order in Case No. 2000-107 (Kentucky Power Environmental Surcharge) the Commission emphasized the importance of assigning costs to the cost-causer.

> *"Finding that the environmental costs should be assigned to the cost-causer, the Commission followed its established precedent in adopting a revenue-based allocation. On appeal, the Franklin Circuit Court affirmed the Commission's allocation of 83 percent of environmental costs to retail ratepayers based on a revenue allocation. Commonwealth of Kentucky v. Public Service Commission at 19.*
>
> *The Court specifically ruled that, 'Because Kentucky Power's system is currently operated to supply wholesale sales for resale, a representative cost allocation must be made to these sales.'* Id.
>
> * * *
>
> *Costs properly allocable to wholesale customers cannot, and must not, be reallocated to retail customers merely because such costs are not being recovered from wholesale customers. Reallocating such costs to retail customers violates the principle that costs be allocated to the cost-causer."*

Case No. 2000-107, February 8, 2001 Order at 5.

This Commission has repeatedly reaffirmed this principle in its recent orders:

The Commission reemphasizes its concern that one segment of LG&E's operation that is earning an excessive rate of return should not subsidize a segment that is under earning. The customers of the individual gas and electric operations should pay no more or no less than the cost of service. ... The primary objective of a cost-of-service study is to determine the rates of return on a company's investment at present and proposed rates for each rate class. ... A cost-of-service study may also be used as a guide in developing an appropriate rate design for each customer class." Case No. 2000-080, September 27, 2000 Order at 66.

* * *

"To adopt Kentucky Power's proposal would require the Commission to abandon the bedrock principle of basing rates on cost causation. Nothing in the record justifies such a drastic step." Case No. 2002-00169, March 1, 2003 Order at 39.

* * *

"Assigning cost liability to the cost-causer is fundamental in utility regulation." Kentucky Power Siting Board, Case No. 2002-00150, December 5, 2003 Order at 11.

The Commiss on Staff considers cost-of-service studies to be of such importance in setting rates that for small utilities without the expertise to perform such studies, the Staff does it for them. See e.g., An Adjustment of the Rates of the Whitley County Water District, Case No. 2000-001, Order entered June 19, 2000 *("Commission Staff prepared a cost-of-service study for Whitley County and has attached this study as Attachment D. A cost-of-service study is necessary to allocate expenses to customers in proportion with the cost of providing service.");* Application of West Daviess County Water District for Rate Adjustment and New Tariff Rates, Case No. 1999-269, Order entered April 12, 2000 *("No cost-of-service has ever been prepared for this utility. A cost-of-service study is necessary to allocate expenses to customers in proportion with the cost of providing service. Commission Staff prepared a cost of service study for West Daviess and has attached this study as Attachment F").*

In addition to Kentucky, it is commonplace in other jurisdictions (at least until those jurisdictions have opted for deregulation) for rates to be set on the basis of cost-of-service. *"Cost allocation is simply an attempt to spread costs among various customer classes on the basis of a factor that is closely correlated with the incurrence of costs".* Re: Kentucky Utilities Co., 15 FERC ¶61,222 (1981). *"The Commission's long standing practice has been to base class revenue allocations on the cost-of-service."* Re: Central Illinois Light Co., 158 PUR 4th 1 (Illinois PSC 1994). The Rhode Island Supreme Court described cost-of-service as the "*golden rule*" of ratemaking and of "*paramount importance*" in rate design.

*"Cost-of-service studies are the most widely utilized tool in developing reasonable public utility rates. James C. Bonbright, Principles of Public Utility Rates, ch. 15 at 375 (2d ed.1988). 'In fact, the golden rule of socially optimal ratemaking is that, whenever possible, prices should track all the identifiable * * * costs occasioned by a service's provision.' Id., ch. 5 at 109-10. We have followed that golden rule of rate making and held that 'it is generally recognized that a cost-of-service study is of paramount importance and may indeed be a precondition to consideration of a proposed rate design.'"*

150 PUR 4th 31, 635 A.2d 1135 (R.I. Supreme Court, 1993). See also Connecticut Power and Light, 144 PUR 4th 161 (Connecticut Department of Public Utility Control, 1993) (Commission moved all rates of return closer to company average thus reducing cost-of-service differentials and improving the state's business climate); Re Niagara Mohawk Power Corp., 140 PUR 4th 481 (New York PSC, 1993) (Commission approved rate design based on cost-of-service study which resulted in residential rate increase of 5.8% versus industrial rate increase of 1.4%); Re North Carolina Power, 142 PUR 4th 117 (North Carolina PUC, 1993) (utility was directed to realign its rates to move toward equalized rates of return. Accordingly, residential customers were assigned a greater portion of the rate increase than the large power customers who had already been paying in excess of their share of costs).

Despite the near unanimous agreement among regulators and experts, including this Commission, that cost-of-service should be the primary factor in determining rate allocation, Attorney General witness, David H. Brown Kinloch advises the Commission to discard the traditional cost-of-service methodology in favor of his "total revenue" methodology.[12] Mr. Kinloch attempts to reconcile the fact that the cost-of-service study submitted by Kenergy definitively establishes that the Kenergy distribution fee for direct serve customers cannot be justified on a cost of service basis with his recommendation that Kenergy's distribution fees for direct serve customers should continue at the

[12] Kinloch Dir. Test. at 7-8. Kenergy President and CEO, Dean Stanley, also briefly advocates "total revenue" considerations in his Rebuttal Testimony at 4, and in Stanley Rebuttal Exhibit 1. KIUC chooses to focus its counter argument on Mr. Kinloch's more detailed explanation of the "total revenue" theory.

current rate by concluding that the traditional cost of service methodology, *"just doesn't work for Direct Serve customers."*[13]

Mr. Kinloch supports his conclusion using a curious, results-oriented approach. Mr. Kinloch observes that the distribution fees paid by Kenergy's direct service customers are only a small percentage of the total cost of power for those customers. The distribution fees paid by Regular Tariff customers make up a larger percentage of the Regular Tariff customers' total cost of power.[14] From this set of facts, Mr. Kinloch concludes that a rate reduction for direct service customers is not justified because the distribution component of their total rate is small on a percentage basis. Apparently, Mr. Kinloch believes that distribution rates should be determined according to the quixotic principle that 'the more you pay, the more you can afford to pay.' As the Commission is well aware, the industrial and smelter customers purchase vast quantities of generation and transmission service at just and reasonable rates as previously determined by this Commission. Those enormous power purchases fuel the economy of Western Kentucky by creating a huge demand for Western Kentucky coal and by directly employing thousands and indirectly tens of thousands. But the generation and transmission component of those power purchases are not an issue in this distribution rate case. Generation and transmission costs are not relevant. Nor would Kenergy's distribution costs be relevant in a Big River's G&T rate case. Mr. Kinloch's theory has no support in the NARUC cost allocation manual and has never been adopted by any other Commission in any other jurisdiction.[15]

Mr. Kinloch's ability to pay theory is as dangerous as it is unsound. Undoubtedly, the Commission would be hostile to this "socializing" of cost notion if it were applied to Kentucky's statewide electric rates. Like Mr. Kinloch, high cost states could argue that because electric rates in

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[13] Kinloch Dir. Test. at 7.
[14] Id. at 7-8.
[15] Kinloch, TE at 150-152.

Kentucky are far below the national average it is "fair" for Kentucky to be over-allocated regional transmission costs because Kentucky can afford it. The methodology proposed by Mr. Kinloch is arbitrary and bears no relationship to the primary consideration of ratemaking: cost-of-service. Mr. Kinloch's "total revenue" methodology is unreasonable and should be rejected.

If there were any basis for the "total revenue" methodology it presumably would have been employed by Kenergy's cost of service expert in this proceeding, Jack D. Gaines. Mr. Gaines has been employed as a cost of service specialist for over 25 years and has testified or assisted in the preparation of cost-of-service studies for cooperatives and municipal utility systems in over a dozen states.[16] Mr. Gaines testified that he "*relied very much, pretty much exclusively, on the* [NARUC] *Cost of Service Manual...*" in preparing Kenergy's cost-of-service study.[17] The study submitted by Mr. Gaines was produced in accordance with accepted cost of service theory and properly does not incorporate the "total revenue" methodology.

Notwithstanding the testimony of Mr. Kinloch, cost-of-service is and has been the primary consideration used in determining rates for Kentucky and other regulated states. In fact, a comprehensive cost-of-service study that separately tracks the costs of providing electric power to direct serve industrial customers was considered so relevant to the issue of the allocation of Kenergy's rates that the Commission postponed a full resolution of this issue in Case No-2000-395 until the present case because Kenergy had failed to produce such a study.[18] As a consequence of the Commission Order in Case No-200-395, Kenergy has at long last submitted cost-of-service evidence reflecting the costs caused by the direct serve industrial customers. KIUC Members have borne excessive and unfair

[16] Gaines, Dir. Test. at 1-2.
[17] Gaines, TE at 98.
[18] Order dated December 11, 2002 in Case No. 2000-395, the Commission directed *"that Kenergy should support its proposed rates with a detailed cost-of-service study that examines in detail the costs of serving direct serve customers..."*

distribution fees for the past three years because cost-of-service data acceptable to the Commission has not been available. Now that Mr. Gaines has finally submitted such information, the Commission should act to adjust rates in accordance with the cost-of-service evidence.

4. The Distribution Rates Of The KIUC Members Should Be Set At Cost

The test year distribution related expenses attributable to the Smelters are $249,412, less $1,768 in interest costs, for net costs of $247,644. Of this total, $178,780 is variable costs, arising entirely from annual fees assessed against Kenergy by this Commission based on kWh sales. Together, during the test year, the Smelters purchased 7,169,800,691 kWh from Kenergy. Accordingly, the evidence reflects that the Energy Charge to the Smelters should be reduced $0.000025 per kWh. [19] The remaining $68,864 of costs incurred by Kenergy in serving the Smelters is administrative in nature and does not vary with the amount of energy that the Smelters purchase. The administrative costs incurred by Kenergy attributable to the Smelters should be collected through a Customer Charge to each Smelter of $2,870 per month.[20]

The test year distribution related expenses attributable to the Big Three Industrials are $111,729, less $778 in costs for interest on debt, for net costs of $110,951. Of this total, $20,255 is variable costs, arising entirely from annual fees assessed against Kenergy by this Commission based on kWh sales. Together, during the test year, the Big Three Industrials purchased 787,708,354 kWh from Kenergy. Accordingly, the evidence reflects that the Energy Charge to the Big Three Industrials should be reduced $0.000025 per kWh (the same as to the Smelters).[21] The remaining $90,696 of costs incurred by Kenergy in serving the Big Three Industrials is administrative in nature and does not vary with the amount of energy that the Big Three Industrials purchase. The administrative costs incurred by Kenergy

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[19] Klepper, TE at 9.
[20] Id. at 9.
[21] Id. at 10.

attributable to the Big Three Industrials should be collected through a Customer Charge to each of the Big Three Industrials of $2,519 per month.[22]

5. The Risk Faced By Kenergy In Serving The KIUC Members Does Not Justify The Current Excessive Distribution Rates Because Kenergy's Risk Is Substantially Mitigated

Kenergy's risk in serving the sizeable loads of the direct service customers does not justify the imposition of distribution fees radically in excess of cost of service, because Kenergy's risks are largely mitigated by several factors. First, Kenergy faces very little risk from its relationship with the Smelters. The Smelters purchase their power from LG&E Energy Marketing ("LEM") through Kenergy by means of its Security and Lock Box Agreement entered into by PNC Bank, LEM and Kenergy's predecessor companies, dated July 15, 1998. Pursuant to this Agreement LEM releases Kenergy from liability in case of a default by the Smelters.[23] Kenergy is merely a pass-through. All monies flow between LEM and the smelters, and Kenergy is subject to no risk.[24] Second, Kenergy currently holds over $7 million in patronage capital from its KIUC Member customers.[25] In the event of a default by one or all of the KIUC Members Kenergy could claim offset rights against that patronage capital and withhold an amount equal to any loss incurred as a result of the default. Third, Kenergy requires and Commonwealth Aluminum provides a one million dollar cash deposit as performance against its power contract. This deposit provides Kenergy with significant protection against a default by Commonwealth.[26] Fourth, although Kenergy was named in the litigation involving a contract dispute between Alcan Aluminum and Dynergy Inc., Alcan has agreed to indemnify and hold Kenergy harmless in that proceeding. Finally, no KIUC Member has ever defaulted on its power contracts and a future default remains unlikely.

[22] Id. at 10.
[23] Security and Lock Box Agreement, Paragraph 5(b).
[24] TE at 15-16
[25] Id. at 16.
[26] Id. at 16.

Kenergy's argument that the risk of serving the Direct Serve customers justifies distribution fees grossly in excess of cost of service is fundamentally flawed and relies on the unfounded notion that the Direct Serve customers are unique among Kenergy customers in exposing it to the risk of default. Every customer served by Kenergy exposes it to the risk of default. The KIUC Members are not distinct in this respect.

6. Sound Economic Principles Indicate That A Rate Reduction For Industrial Customers Will Benefit Kentucky More Than A Rate Reduction For Commercial Customers

While cost of service should be the primary consideration in setting rates, it is important to also consider the growth and development of Kentucky's economy when allocating a rate increase or decrease among commercial and industrial customers. Even though Kenergy's cost-of-service study shows that some commercial customers are being overcharged by even more than the direct serve customers, it is a more sound economic policy to ensure that industrial rates are at cost. Moreover, the patronage capital evidence supports this conclusion. There is no evidence in this record regarding the patronage capital balances of the commercial customers.

It is imperative for Kentucky to maintain its historically low industrial power costs in order to protect Kentucky's economy and promote growth. Obviously, low power costs benefit all businesses, commercial or industrial, however low power costs are especially crucial to industrial customers that compete in a national or international market and in energy intensive industries such as the aluminum industry.

Low power costs are vitally important to industrial customers competing in a global market relative to commercial customers who compete in an instate, regional market. This principle can be established through a simple example. A commercial customer in Kentucky, a Wal-Mart store for example, faces its primary competition from other retailers in the same electric service territory, perhaps a K-Mart or Target store. An increase or decrease of power rates will not confer an advantage or disadvantage on any single competitor because they are all served by the same utility at presumably the same rate. Power costs are not an important factor in the competition between the commercial customers because they are all competing for the same shoppers in the same region and power costs are the same for all of the commercial customers in that region. A rate decrease is not competitively significant because a decrease for one competitor is a decrease for all competitors.

In contrast, the fates of industrial customers that compete in national and international markets are greatly affected by fluctuations in the price of power. An aluminum smelter in Kentucky competes with smelters outside of Kentucky for its customers. Indeed, much of the success enjoyed by Kentucky industrial customers can be attributed to the Commonwealth's low energy costs.

Compounding the importance of low cost power for Kentucky industrial customers relative to commercial customers is that much of Kentucky's economic strength depends on the success of maintaining and attracting industrial power users. Unlike most commercial businesses in Kentucky, the addition of new industrial businesses represents an incremental economic gain to Kentucky's economy. To briefly revisit the above example, when a new commercial business, again Wal-Mart, opens a store in Kentucky the jobs created by the Wal-Mart store are offset by the jobs lost from the corresponding elimination of competing businesses. The regional economy may not enjoy any growth at all as a result of the new commercial business because its success comes at the expense of other local commercial businesses. In contrast, industrial businesses that compete in a national market locating in Kentucky always represent a net gain for the regional economy because their primary competition is from businesses located outside of the Commonwealth. It is fair, just and reasonable to take into consideration that economic growth in Kentucky is to some extent dependant upon low cost industrial power.

Aluminum smelters thrive in Kentucky in large part because of Kentucky's low power costs. The *North American Business Cost Review, 8th Edition* ranks Kentucky as having the second lowest cost power in the United States as of the year 2000.[27] In return the Smelters provide thousands of jobs at an average salary greatly in excess of salaries found in other industries. In its September 2002 report on the aluminum industry in Kentucky, the Kentucky Cabinet for Economic Development[28] noted the importance of the continued success of the aluminum industry in Kentucky. "*Aluminum-related companies have over 17,500 employees, which is 5.7 percent of all manufacturing employees* [in Kentucky]... *The aluminum industry has and continues to impact the economy and people of Kentucky in a very positive manner. The aluminum industry provides thousands of well paying jobs to the people of Kentucky. The average weekly wage for the Primary Aluminum industry in Kentucky is $863 compared to $732 for manufacturing industries and $570 for all industries. In 2000, the Primary Aluminum industry added over $741 million of value to the Kentucky economy, and the value added by the Kentucky aluminum industry grew by over 10 percent from 1997 to 2000.*"[29] Given the important role that Kenergy's industrial customers play as a driving force behind the growth of the Kentucky economy the proposed decrease in distribution rates is reasonable.

[27] KIUC Cross Examination Exhibit 2, at 9.
[28] See KIUC Cross Examination Exhibit 2
[29] Id. at 9.

7. <u>The Provision Of Kenergy's Rate Agreement With Weyerhaeuser That Requires Weyerhaeuser To Pay A Distribution Fee On Energy Generated On-Site Is Unreasonable</u>

In 2001 Willamette Industries, later acquired by Weyerhaeuser, installed cogeneration equipment in its Hawesville facility that uses the steam expelled in the manufacturing process as a source of electric generation. Under federal law, Section 210 of the Public Utilities Regulatory Policies Act of 1978 (PURPA), and the regulations of this Commission, 807 KAR 5:054 Small Power Production And Cogeneration, Kenergy is required to supply "*supplementary power, back-up power and maintenance power*" to the Weyerhaeuser cogeneration plant at rates that are "*just and reasonable, in the public interest and non-discriminatory*". The terms and conditions for the sale of back-up power are set forth in an "Amended and Restated Agreement for Retail Electric Service to Willamette Industries, Inc." dated April 4, 2001, between Kenergy and Weyerhaeuser, as amended February 6, 2003. There is a corresponding "Amendment to Wholesale Power Contract" dated April 4, 2001 between Big Rivers and Kenergy. Both the Weyerhaeuser rate agreement and the corresponding wholesale contract have been filed with and accepted by the Commission.

Section 37 of the Weyerhaeuser Rate Agreement requires Weyerhaeuser to pay to Kenergy a distribution fee on all energy that Weyerhaeuser consumes at its Hawesville facility, regardless of whether such energy is purchased from Kenergy or generated on-site. In other words, Weyerhaeuser is required to pay Kenergy a distribution fee on cogenerated power consumed on-site by Weyerhaeuser, even though the cogenerated power never touches the Kenergy distribution system, never touches the Big Rivers transmission system and Kenergy incurs no costs on such cogenerated power. There is no cost of service justification whatsoever for charging a distribution fee on cogenerated power consumed on-site.[30] The only cost that Kenergy incurs that varies based on the amount of energy consumed by

[30] Klepper, TE at 15.

Weyerhaeuser is the annual fee paid to the Commission ("PSC fee), which fee is calculated and assessed based on Kenergy's energy sales, and which calculation does not include energy self-generated by Weyerhaeuser.[31] If Kenergy's energy sales are reduced due to Weyerhaeuser's self-generation, then Kenergy's costs are correspondingly reduced, because Kenergy does not pay the PSC fee on that power. As a result, Kenergy makes more profit on energy produced by Weyerhaeuser than on energy Weyerhaeuser buys from Kenergy, because when Weyerhaeuser produces its own electricity Kenergy collects the same distribution fee as if the electricity was purchased from Kenergy but Kenergy does not pay a PSC fee on that energy.[32]

For the test year 2002, Weyerhaeuser purchased 306,103,294 kWh from Kenergy. Under the proper application of the existing rate, Weyerhaeuser's total distribution fees for 2002 would have been $91,220.66. Instead, because self-generated energy was included in Kenergy's calculation, Weyerhaeuser's payment of distribution fees for 2002 was $166,889.02. During 2002, this unreasonable calculation by Kenergy cost Weyerhaeuser $75,668.36.

It is important to recognize that KIUC is not advocating that the terms of the special contract be broken or revised. The contract itself clearly states that the amount of the distribution rate is subject to future Commission modification in Kenergy rate cases. The Agreement states that all parties shall have the right to petition the Commission for adjustments to the distribution fee and that in future rate cases Willamette/Weyerhaeuser may assert that the distribution fee is excessive in relation to Kenergy's cost of service, but that Willamette/Weyerhaeuser cannot argue that its distribution fee should be reduced solely based upon the fact that it is imposed on self-generated power.[33] KIUC's arguments in this proceeding have been consistent with this provision. There is no cost-of-service justification for

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[31] Id. at 15.
[32] TE at 28.
[33] Klepper, Dir. Test. at 35. Exhibit No. 2, Section 37.

charging a distribution fee on self-generated power that never touches the Kenergy distribution system, never touches the Big Rivers transmission system, and which causes Kenergy to incur no costs.

The Weyerhaeuser contract is not a fixed-price contract. KIUC is not asking the Commission to break a contract. The contract specifically authorizes the Commission to change the distribution fee (up or down) in future Kenergy rate cases based on cost of service principles.

8. The Requested Rate Decrease Does Not Require Kenergy To Raise Rates To Other Customers Or Threaten Kenergy's Financial Viability

Kenergy can absorb the proposed rate decreases. Assuming that the Commission approves distribution fees to the KIUC Members exactly as proposed herein, the annualized revenue reduction to Kenergy would be $469,320. Kenergy would have to absorb this revenue reduction for less than a year. From the time of the Commission's rate order in this proceeding until September 1, 2004, the date on which Kenergy's Consolidation Credit Rider will expire by its own terms after being in place for five years. Upon expiration of the Consolidation Credit Rider, Kenergy's revenues will increase by approximately $2.5 million per year.[34] Thus, the distribution fees to be paid by the KIUC Members can be decreased to reflect cost of service without any immediate corresponding rate increase to any other customer class.

In sum, the revenue loss to Kenergy from setting rates based on cost as proposed herein will be more than made up by the $2.5 million increase in revenue that will occur when the Consolidation Credit expires. Kenergy can internally fund the rate changes. Kenergy is very strong financially. For the test year its per books TIER was 2.07. Accepting without challenge all of Kenergy's proforma adjustments (which reduced its total margin by almost 23%) results in a proforma test year TIER of

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[34] Klepper Dir. Test. at 12.

1.94. For the six year period 1997-2002, its per books TIER averaged 1.83. The RUS requires a minimum TIER for Kenergy of between 1.0 and 1.25. Using Kenergy's proforma test year results, the Company could absorb a revenue reduction of $2.3 million and still meet the RUS 1.25 minimum TIER. Of course, instead of being subject to a rate decrease of $2.3 million, Kenergy is on schedule to receive a rate increase of $2.5 million in 2004.[35]

[35] Id. at 13.

IV. CONCLUSION

The evidence in this case conclusively shows that the distribution fees to the Big Three Industrials and Smelters are grossly in excess of the cost-of-service. Accordingly, the rates to those customers should be set at cost so the $7 million excess patronage capital balance is not increased.

Respectfully submitted,

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